EBMUD

Policy 4.27

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SUPERSEDES NEW

DEBT MANAGEMENT

IT IS THE POLICY OF EAST BAY MUNICIPAL UTILITY DISTRICT TO:

Manage debt issuance and administration in a manner that is prudent, financially sustainable, in the best interest of ratepayers, and generally consistent with industry best practices.

Purpose

This policy describes and specifies the District's actions related to debt obligations. It is meant to outline what constitutes appropriate management of the District's debt portfolio. The District's Board of Directors (Board) may approve bonds that deviate from this policy. Failure of the District to comply with any provision of this policy will not affect the authorization, validity, or enforceability of any bonds or other forms of indebtedness that are otherwise issued in accordance with applicable law.

Purpose of Debt

The general purpose of long-term debt is to spread the cost of capital assets over a longer time period than simply paying as costs are incurred. This allows the impact on rates to be spread over time and aligns the cost of assets to the estimated life of those assets. It is the policy of the District to issue debt to finance previous or anticipated capital expenditures. District staff will identify the specific purpose of the debt issue into a debt obligation. The types of debt described in this policy will not be used to finance operating expenditures. The primary reasons for this are, firstly, to spread out the impact on rates of particularly large capital expenditures; and secondly, to more closely align the payment of asset costs to the estimated life of the assets.

Legal Authority

The District has the legal authority to enter into debt obligations. This authority is given to the District by various state and federal codes (tax law for tax-exemption) as well as the Municipal Utility District Act ("MUD Act"), certain provisions of which are referenced below.

1. <u>Revenue Bond Authorization</u>

   Under the MUD Act (Article 6a of Chapter 6), the District has authority to issue bonds payable from revenues of the water or wastewater system in accordance with the Revenue Bond Law of 1941 (Bond Law) found in the California Government Code, with specified exceptions from the provisions of the Bond Law.

   The Board must authorize the District to sell long-term revenue bonds through a formal resolution, specifying, among other things: the maximum principal amount of bonds proposed to be issued; the maximum term of the bonds; and the maximum interest rate to be payable on the bonds. The authorized bonds may be issued from time to time in series. The resolution adopted by the Board authorizing the issuance of revenue bonds is subject to the right of referendum. Staff will request this preliminary bonding authority from the Board periodically to ensure the amount authorized at any given time is sufficient to cover any expected bond sales.

   In addition, staff will present and ask the Board to approve its expected debt financing plan annually at the beginning of each fiscal year.

2. Short-Term Borrowing Authorization

   The MUD Act (Chapter 7.5) also authorizes the issuance of short-term bonds, notes and other forms of indebtedness (including through or with bank credit) with maturities not exceeding seven years. Short-term indebtedness must be authorized by resolution of the Board, which resolution is subject to a right of referendum. Under the MUD Act, the maximum amount of all such short-term indebtedness (including amounts drawn under available bank lines of credit), shall not at any one time exceed the lesser of either (1) the annual average of the total revenue for the three preceding years or (2) 25% of the District's total outstanding bonds issued pursuant to Chapter 6, Chapter 7 and Chapter 8 of the MUD Act. Successive issues of short-term indebtedness may be authorized from time to time.

3. Other Forms of Borrowing

   From time to time, the District may incur other forms of indebtedness as authorized by the MUD Act, including loans and other arrangements with the State (Section 12802) or federal government (Section 12844), general obligation bonds (Chapter 7), assessment bonds (Section 12921 and 13010) and emergency financing (Chapter 7.1), subject to the limitations contained in the MUD Act.

Types of Debt

The District has the ability to enter into various types of debt obligations. Debt obligations can be short-term or long-term in nature, as well as tax-exempt or taxable. Brief descriptions of these financing instruments are provided below.

Long-Term Debt

Long-term debt generally encompasses debt issued to finance capital expenditures with the objective of structuring repayment to match the expected life of the asset financed. It can be used as a tool for maintaining rate stabilization as repayment is spread over the useful life of the project. Long-term bonds can be fixed or variable rate with serial or term maturities. Revenue bonds are historically the primary form of long-term debt obligation entered into by the District. The District has also issued General Obligation Bonds based on voter approved bond measures.

The repayment of long-term revenue bonds is secured by a lien on revenues of the District. In essence, it is the net revenues that are pledged to pay debt service. Net revenues are defined generally by the District's bond indentures as all System revenues less all operation and maintenance costs. The District may issue revenue bonds that are secured by liens on net revenues that are either senior or subordinate in relation to each other.

General obligation bonds are another type of long-term bonds available to the District. The issuance of general obligation bonds requires a two-thirds vote of the electorate. These bonds have been used less frequently by the District. General obligation bonds are payable by a dedicated property tax, and do not have a claim on the District's other operating revenues.

The District may also enter into long-term loans with state or federal agencies. These loans typically have fixed interest rates. Government loan programs can offer favorable interest rates, and should be considered as alternatives to market rate debt when available.

Short-Term Debt

Historically, short-term notes and commercial paper have been the most commonly issued by the District. Short-term debt, like long-term debt, can be issued by the District at various lien levels but is most typically secured by net revenues on a subordinate basis to the District's long-term bonds.

One common reason to issue short-term debt is to secure funding for a capital project or group of capital projects during the construction period. Once the construction period is complete, the short-term debt may be refinanced, or "taken out," with long-term debt that matures over a period of time more closely matching the lifespan of the assets that were built.

Direct bank loans are another type of short-term debt obligation the District may enter into over time, and could be issued with either fixed or variable rates and generally over a term extending from one to seven years.

Debt-Related Instruments

The District may enter into other debt-related arrangements that include interest rate swaps, letters of credit, and standby bond purchase agreements. Policy 4.23 (Interest Rate Swap Policy) sets forth the District's policy on swaps.

Because variable rate debt generally requires remarketing agents to periodically remarket the debt to investors, bank credit or liquidity facilities in the form of a letter of credit or standby bond purchase agreements or similar arrangements are required to provide credit and/or liquidity support. Such bank facilities are generally for terms that are shorter than the debt that they support, and therefore need to be renewed periodically throughout the life of the related debt. These renewals will be brought to the Board for approval in advance of expiration.

Types of Bond Issuance

The District may issue taxable or tax-exempt bonds. Tax-exempt bonds are usually the preferred type of bonds given that they typically provide the lowest interest cost. Tax-exempt issuance must adhere to all applicable federal tax laws.

Types of bond issuance include:

1. New Money

   "New money" bonds are issued to provide the District with funding for capital expenditures. New money bonds may fund upcoming capital expenditures or reimburse the District for capital expenditures already incurred. Significant restrictions exist around public purpose versus private activity use of bond proceeds. Taxable bonds can be used for projects and structures where IRS tax-exempt regulations cannot be met, such as those with private benefit.

2. Refunding

   Refunding bonds may be issued to refinance existing bonds to achieve debt service savings. Staff works with the District's financial advisor to assess potential savings and determine whether refunding bond issuance is warranted.

3. Restructuring

   From time to time, the District may issue refunding bonds to restructure the type of debt outstanding, the "shape" of future debt service payments, or to take advantage of market opportunities.

Sale Method

The District may choose to issue bonds using either a competitive or negotiated sale process. The District may also sell bonds by means of a private placement or direct sale with a financial institution or other accredited investor when this method is demonstrated to result in cost savings or provide other advantages relative to a traditional public offering. Staff will work with the District's financial advisor to determine the most appropriate method of sale for each issuance.

Structure and Term

The repayment schedule of a bond issue can vary greatly from one sale to another. The same is true for other debt instruments. The District will consider which structures are most cost effective for ratepayers, the new debt's impact on the District's overall debt service schedule, future debt capacity, and other factors when deciding how to structure new debt. In addition to debt amortization terms, structuring options may include procuring credit enhancement, the establishment of reserves, the use of capitalized interest, and appropriate call options.

Goals and Objectives

Long-term financial stability is the primary underlying objective the District will consider when making decisions related to debt.

When it deems debt as the most appropriate source of funding, the District must seek to keep the cost of the debt, including the cost of issuance, as low as can be reasonably achieved. Given that interest costs can have a major impact on the District's budget and rates, efforts should be made to achieve low interest rates on new debt and to achieve interest rate savings when practicable. Short term variable rates will usually offer the lowest interest rates but do expose the District to long term interest rates risk to the extent those rates are left unhedged. Achieving the lowest interest rates must be carefully balanced against long-term financial stability.

Credit ratings have a significant impact on the interest rates at which the District borrows. Therefore, efforts should be made to maintain strong credit ratings through strong financial decision-making. In addition, marketing efforts should be undertaken when practical to ensure the District's name and credit are in good standing with municipal bond investors.

1. CIP and Budget

   The District's capital and operating budgets are key to estimating the timing of and need for future borrowing. While debt will generally only fund capital expenditures, and not operating costs, the amount of debt issued can still have an indirect effect on operating performance due to its impact on cash reserves and water/wastewater rates. Staff will analyze the budget projections throughout each fiscal year, including expected cash reserves and required rate increases. This information will provide the basis for decisions regarding how much, if any, debt to issue in each year.

   In addition, staff will monitor the capital improvement program to identify upcoming projects that may be appropriate candidates for state or federal loans.

2. Ratio Targets

   When deciding on the amount of current and future debt to issue, staff must pay particularly close attention to certain financial ratios. The most important of these is the debt service coverage ratio, which is generally expressed as annual net revenues divided by annual debt service.

The District has a legal covenant to maintain the debt service coverage ratio at a minimum of 1.1. Under no circumstances should the District allow its debt service coverage ratio to fall below 1.1 as calculated under its bond indentures and other debt documents. State and federal loans also have coverage requirements that may differ from what is required by bond documents.

The District's long-term goal may evolve over time to target a debt service coverage ratio that allows for full cash funding of a base level of capital spending. In the meantime, it is the District's policy to maintain debt service coverage (as calculated under its bond indenture) at or above 1.6.

Another ratio that helps measure the District's financial health is the ratio of debt-funded capital to overall capital spending. This can be measured in any given fiscal year as well as over a rolling period of years. The ideal percentage of debt-funded capital will fluctuate over time. However, the District will strive to maintain this ratio below 65% in each five year planning period.

While variable rate debt typically has a lower cost of borrowing than fixed rate debt, it carries the risk of increasing interest rates and market volatility. Given the added risk that variable rate debt adds to the District's budgetary performance, the amount of variable rate debt outstanding in either the Water or Wastewater Systems will not exceed 25% of the total amount of long-term debt outstanding in either system.

Bond Sale Process

The process of selling bonds takes the careful coordination of a number of participants including the District's staff, its financial advisors and bond counsel, third-party bond trustee or paying agent, verification agent, underwriters, broker-dealer, rebate consultant, bank liquidity and credit provider, and/or rating agencies.

1. <u>Preparation</u>

   The District relies on its bi-annual budget as the basis for financial estimates that underlie how much, if any, new debt should be issued in any given year. In addition, staff monitors the municipal bond market to identify opportunities to save costs by issuing refunding bonds. In either case, once it is determined that debt issuance is appropriate staff begins the process by coordinating dates and milestones with the District's financial advisors and bond counsel.

   While there are many different tasks to perform during the preparation, one of the most critical and involved is the preparation of the Official Statement and its accompanying Appendix A. These disclosure documents are distributed to potential investors in and purchasers of the District's bonds and provide information needed to make an informed investment decision. These documents are subject to federal securities laws and are required to be accurate and current, and not contain material misstatements or omissions. Policy 4.26 (Municipal Securities Disclosure Policy) sets forth the District's disclosure policies.

2. <u>Board Authorization</u>

   Before the District can issue new bonds, the Board must authorize the sale. Staff will generally ask for the Board's authorization to approve documents and proceed in the financing transaction once the structure and major aspects of the sale are determined.

3. <u>Execution</u>

   Once the Board has approved a particular bond issuance, staff is authorized to execute the transaction within the authorized parameters. Depending upon the method of sale chosen (negotiated or competitive), staff will work with its financial advisor along with any underwriters that may be involved to finalize the bond sale.

4. <u>Handling of Bond Proceeds</u>

   Proceeds of debt should be held either by a third-party trustee or by the District. A third-party trustee will disburse bond proceeds to the District upon submission of one or more written requisitions signed by an authorized District officer. If the funds are held directly by the District, they must be held and accounted for in a separate fund or account, the expenditure of which will be carefully documented by the District and subject to established internal controls consistent with the District's applicable policies and procedures. These procedures will include, in connection with each requisition or expenditure of proceeds held by the District, a written record of the particular capital project or program or other expense to which the funds drawn were applied or allocated.

   For bond proceeds that are meant to reimburse the District for previous expenditures, District staff will certify that the reimbursing proceeds comply with all tax requirements and other regulations. To support this certification, staff will analyze capital expenditures and ensure that all requirements are met before the bond issuance takes place and maintain a written record of such analysis and the amount reimbursed to each particular capital project or program or other expense to which such reimbursed proceeds are to be allocated.

   For bond proceeds meant to provide funding for ongoing or upcoming capital expenditures, District staff will ensure proceeds are spent according their intended purpose as well as all regulations. Staff will analyze the use of proceeds on an annual basis or more frequently, if necessary, until the proceeds are completely spent and will perform monitoring and record-keeping in accordance with any applicable post-issuance compliance procedures and guidelines of the District.

   For bond proceeds meant to refund existing bonds, such funds will generally be held by a third party trustee or fiscal agent to be applied in connection with written directions generally prepared by or in consultation with bond counsel to ensure funds are used according to legal requirements. The District will maintain records of the directions to, and will perform timely review of fund statements and other records received from, the third party agents.

Post Issuance Administration

The District will comply with all requirements pertaining to initial bond disclosure, continuing disclosure, tax-exemption, post-issuance compliance, and investment of bond proceeds. This includes any continuing disclosure undertakings under SEC Rule 15c2-12; tax covenants and related federal tax compliance requirements such as arbitrage restrictions and rebate requirements; and all California State reporting requirements.

1. Financial Disclosure

   The District must comply with all ongoing deliverable obligations and financial disclosure requirements, as specified in any and all bond and debt-related documents. Policy 4.26 (Municipal Securities Disclosure Policy) sets forth the District's disclosure policies. Staff has developed and will maintain an updated schedule of the requirements, and ensure there is redundancy in the internal processes to ensure compliance with all timelines and prevent any missed deadlines. The District will post required documents to the MSRB's EMMA website and deliver periodic deliverables on or before the dates by which it is required to do so by its bond documents. The District, at its discretion, may also post documents to EMMA that it believes are relevant to bondholders, but that are not required to be posted. The Treasury Division is responsible for ensuring all District actions related to financial disclosure are completed as required.

2. Tax Compliance

   The District will comply with federal arbitrage and rebate regulations related to its bonds and other debt instruments. These responsibilities include monitoring the investment and expenditure of bond proceeds, maintaining a system of record-keeping and reporting and contracting for the services of outside arbitrage consultants as necessary. The District has established and implemented post-issuance procedures to guide its compliance with these requirements. The Treasury Division is responsible for ensuring all District actions related to tax compliance are completed as required.

Authority

Resolution 35192-20, July 28, 2020

References

Policy 4.23 – Interest Rate Swap Policy
Policy 4.26 – Municipal Securities Disclosure